Economics

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BI Holds Rate At 5.75% Amid Capital Inflows, Signals Resumption Of Tightening Amid Geopolitical Risks

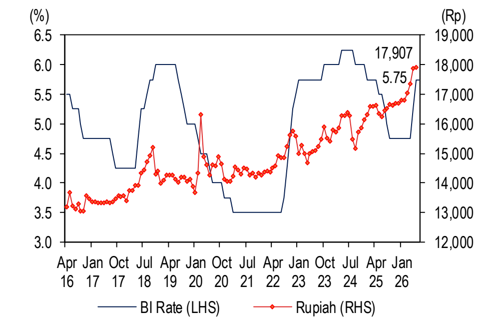
Highlights

- **Rate hold and policy easing measures.** Bank Indonesia (BI) kept the BI rate at 5.75% in Jul 26, supported by improved capital inflows and rupiah appreciation. Alongside this pause, BI introduced additional liquidity-boosting measures, including raising the KLM incentive to 6.0% of DPK (unlocking Rp 50t–53t) and increasing swap discounts for foreign investors, although banks remain reluctant to channel funds into credit amid worsening risk perceptions.
- **Geopolitical and oil price risks increasing.** The outlook is clouded by persistent Middle East conflicts and elevated global energy prices, which could undermine foreign appetite for Indonesian assets, pressure fiscal credibility, and potentially trigger renewed dollar strength - forcing markets to demand higher risk premiums on Indonesian securities.
- **Projected BI tightening amid hawkish Fed.** We expect BI to resume the rate hike in 2H26 with two rounds of 25bp increases, followed by another 25bp in early-27, bringing the terminal rate to 6.50% (the highest since 2016). This will flatten the yield curve, presenting a strategic opportunity for investors to accumulate short-tenor (below five years) and medium-tenor (5–7 years) bonds.

Analysis

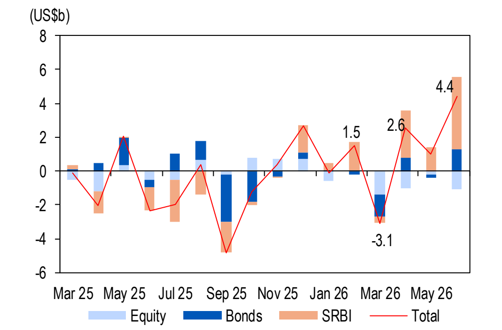
- BI temporarily paused its monetary tightening cycle, maintaining the BI rate at 5.75% during its Board of Governors meeting in Jul 26, in line with our forecast but contrary to market consensus of a 25 bp rate hike to 6.00%. Prior to the July meeting, BI had aggressively hiked its policy rate by a cumulative 100bp, marking a complete reversal from the dovish stance that prevailed in early-26.
- The decision to hold was largely driven by improving capital inflows into Indonesia's capital markets - namely bonds and short-term SRBI instruments. This improvement stems from both global and domestic factors. On the global front, declining US inflation and subdued inflation expectations have slightly dampened market expectations for Fed rate hikes in 3Q26.
- Domestically, the government's decision to further cut the budget for expansionary social expenditures has boosted investor sentiment toward Indonesia's fiscal policy. Additionally, rising bond yields and relatively low valuations of Indonesian stocks have increased the attractiveness of domestic assets for foreign investors. On the risk perception front, S&P's decision to maintain Indonesia's stable outlook and BBB investment-grade rating has led to a slight improvement in risk appetite.
- Consequently, the rupiah has appreciated over the past month, along with other emerging market currencies, aided by a weaker US dollar amid diminishing expectations of Fed hikes in the short term.
- In addition to holding the rate firm, BI also introduced additional policy measures. First, the central bank will raise the swap discount provided to foreign portfolio investors from 10% to 12.5%, alongside a 15% discount on domestic non-deliverable forward hedging. These measures are expected to further accelerate capital inflows into Indonesia's financial markets, particularly if global and domestic sentiment remain positive.
- Second, BI will increase its macroprudential policy incentive (KLM) by raising the maximum total KLM receivable by banks to 6.0% of Third-Party Funds (DPK), up from 5.5%. This is projected to release Rp50t–53t in banking

BI Rate and Indonesia Exchange Rate



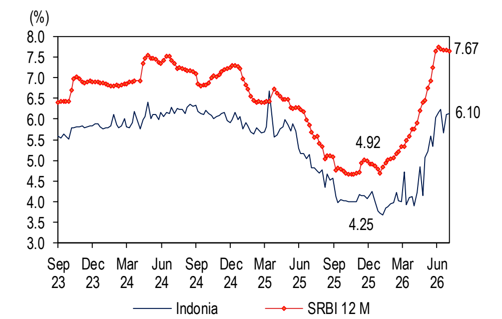
Source: Bloomberg

Capital Flow Into Indonesia Financial Market



Source: Bloomberg

12 Month SRBI Yield And Interbank Rate



Source: Bloomberg

liquidity to support credit disbursement and ease pressures in the banking system.

- However, in our view, liquidity in the economy and banking system remains ample. However, banks are increasingly allocating funds toward short-term SRBI and SBN instruments amid worsening credit perceptions and macro headwinds. As a result, SRBI yields have become the benchmark rate for the economy, with banks preferring SRBI allotments over interbank placements or credit disbursement, particularly as credit yields remain compressed due to intense competition for corporate loans and deteriorating consumer risk profiles.

Outlook

- We view BI's new policy approach - leveraging foreign capital inflows - as a laudable move, as it helps avoid further domestic slowdown while supporting rupiah stability. Nevertheless, this strategy is not without risks, notably the persistently volatile geopolitical landscape, which could significantly impact foreign appetite for Indonesian assets. Further geopolitical deterioration or renewed dollar strength could force another round of market repricing, demanding higher spread premiums to hold Indonesian assets. Surging oil prices driven by geopolitical tensions could also place Indonesia's fiscal policy back under the spotlight and weaken appetite for its fixed-income securities.
- In this context, we maintain our assumption that the current Middle East conflict will persist throughout 3Q26, keeping global energy prices elevated throughout 2026 before moderating in 2027. This backdrop is likely to trigger a mini hiking cycle by the Fed, with markets forecasting a 25bp hike in 2H26 and another 25bp in early-27.
- Consequently, we expect BI to resume its tightening cycle, delivering two rounds of 25bp rate hikes in 2H26 and bringing the BI rate to 6.25% by end-26 to preserve its spread over US policy rates. For 2027, BI is also likely to deliver a further 25bp hike, resulting in a terminal rate of 6.50%, which is the highest since 2016.
- These global and domestic developments reinforce our view that Indonesian bond yields are likely to rise, as widening policy rate spreads push yields across both short- and long-tenor bonds. The yield curve is also expected to flatten further as short-term yields climb in response to BI's hikes, presenting a buying opportunity for investors in short-tenor (below five years) and medium-tenor (5-7 years) bonds.